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RUCPDOG/DEPT OF COMMERCE WASHDC  
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C O N F I D E N T I A L BAKU 000667

SIPDIS

DEPT FOR EUR/CARC  
DEPT PASS TO TDA FOR STEIN, EXIM FOR GLAZER  
ANKARA FOR FCS  
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E.O. 12958: DECL: 07/10/2018  
TAGS: [ECON](#) [EINV](#) [ETRD](#) [ENRG](#) [EFIN](#) [AJ](#)  
SUBJECT: AZERBAIJAN INCREASES 2008 BUDGET WITH LARGE  
TRANSFERS FROM STATE OIL FUND

REF: (A) BAKU 291 (B) BAKU 429 (C) BAKU 322

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B, D)

¶1. (C) SUMMARY: With the May 2 approval of the 2008 supplemental budget by Parliament, the Government of Azerbaijan (GOAJ) increased expenditures by USD 3.7 billion, raising total expenditures to USD 12.2 billion. In order to fund the dramatic increase in expenditures, the GOAJ will increase the total amount transferred from the State Oil Fund to the budget by USD 3.2 billion to USD 4.4 billion. Transfers in 2008 from the Oil Fund to the budget could total more than 50 percent of the Oil Fund's total revenue inflows this year. In this presidential election year, the supplemental budget boosts defense, health and education spending. Defense will receive USD 1.6 billion and the GOAJ plans to spend USD 5.1 billion on public capital investments, including USD 1.29 billion on highway, energy, transport, and gas infrastructure upgrade projects. The international financial institution (IFI) community has expressed concern regarding the GOAJ's expansionary fiscal policy, especially noting how the GOAJ is using the Oil Fund. The IMF has raised its 2008 inflation estimates for Azerbaijan to more than 26 percent. END SUMMARY.

BUDGET EXPENDITURES UP 30 PERCENT  
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¶2. (C) Azerbaijan's Parliament on May 2 approved an annual supplemental budget expenditure increase of USD 3.7 billion, an increase of 42 percent, pushing the total 2008 budget expenditures in excess of USD 12.2 billion, an increase of 35 percent from 2007. In 2007, Azerbaijan increased its budget expenditures in the supplemental budget by more than USD 750 million. The large supplemental budget package was not unexpected and includes large increases in defense, health and education expenditures. Worrisome to many financial observers in Baku, however, is the large transfer from the State Oil Fund to support the large increases in budget expenditures. Finance Minister Sharifov told a visiting USG official that the GOAJ will begin preparations for the 2009 state budget in early September but he did not comment on the potential increase in the budget.

¶3. (SBU) In the supplemental budget, the GOAJ will increase defense spending to USD 1.6 billion, an increase of approximately 32 percent from the original budget proposal. In addition, the GOAJ will increase healthcare spending by almost 17 percent with funding totaling USD 454 million. The

government will spend more than USD 200 million on hospital upgrades and more than USD 60 million on outpatient services.

The Government plans to spend an additional USD 150 million for "other healthcare services." The Government also increased education spending by 14.5 percent bringing the total to USD 1.31 billion.

¶4. (SBU) Also included in the supplemental budget is an increase in capital investments. In 2008, the Government plans to spend USD 5.1 billion on public capital investments, including USD 1.29 billion on highway, energy, transport, and gas infrastructure upgrade projects. The GOAJ is currently implementing a multi-year capital investment program in order to modernize the infrastructure of the country and the increase in the supplemental budget is part of this broader, ongoing effort. (COMMENT: It is unclear if the GOAJ has effectively planned for the large increase in expenditures or performed cost-benefit analysis, especially with respect to the half of the spending which will go for public investments. END COMMENT).

#### OIL FUND TRANSFERS TO THE BUDGET

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¶5. (C) In 2008, the GOAJ will transfer a total of more than USD 4.4 billion from the State Oil Fund to the state budget for support, including the USD 3.2 billion planned in the supplemental budget. In 2008, the Oil Fund expects to receive more than USD 8 billion in oil revenues and its assets will increase to nearly USD 10 billion. Transfers in 2008 from the Oil Fund to the budget could total more than 50 percent of the Oil Fund's total revenues this year. According to press reports, Minister Sharifov has stated that

Azerbaijan's foreign exchange reserves grew 25 percent from January to March 2008 to USD 9 billion.

¶6. (C) COMMENT: The State Oil Fund, Azerbaijan's most transparent government agency, acts as Azerbaijan's energy revenue sterilizer and long-term savings vehicle. It is also used to support key national development objectives and programs. The GOAJ's reliance on the Oil Fund for budget support while addressing important national development priorities, impacts its effectiveness in insulating the Azerbaijani economy from the negative effects of its burgeoning inflow of energy revenues, especially inflation. It also raises concerns about the Oil Fund's ability to fulfill its role of safeguarding energy revenues for Azerbaijan's long-term sustainable development. END COMMENT.

#### STEADY ECONOMIC GROWTH

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¶7. (C) While still growing, Azerbaijan's economy is poised to slow in 2008 after four years of extremely rapid growth and the maturing of Azerbaijan's energy sector. According to the Azerbaijani State Statistics Committee, Azerbaijan's Gross Domestic Product grew 13.8 percent year-on-year to USD 9.6 billion from January to March 2008. Azerbaijan is forecasting that GDP will reach USD 37 billion in 2008. In July, the GOAJ announced a series of salary increases for government employees, including Azerbaijani military officers and Ministry of Internal Affairs employees. According to the State Statistics Committee, the average nominal monthly wage increased 26.5 percent year-on-year to USD 271 from January to March. The GOAJ had planned to increase salaries throughout 2008 in the run-up to the October presidential election.

#### IFI REACTION

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¶8. (C) In discussions with representatives from the International Monetary Fund, European Bank of Reconstruction and Development, World Bank, and International Financial Corporation, all expressed concern regarding the Government of Azerbaijan's expansionary fiscal policy, and the large increase in spending included in the 2008 supplemental

budget. The IFIs are also concerned by the GOAJ's reliance on the Oil Fund for budgetary support, as it risks diminishing the fund's sterilizing function. The IMF representative said that inflationary pressures would continue to mount in 2008 and continue into 2009. The IMF has raised its 2008 inflation estimates for Azerbaijan to more than 26 percent. Other local economic observers expect inflation in 2008 to surpass 30 percent.

COMMENT

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19. (C) With the presidential election scheduled for October, many IFI observers believe that some of the additional spending is politically motivated. The macroeconomic effects of the large increase in spending included in the supplemental budget will probably not be felt until early 2009 as it will take the GOAJ several months to disburse funds. The government's increasingly expansionary fiscal policy continues to be worrisome as inflationary pressures increase. In the current expansionary environment, inflation is unlikely to decrease and the government's efforts to raise salaries and wages could lead to the wage-price spiral that damages long-term economic stability.

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